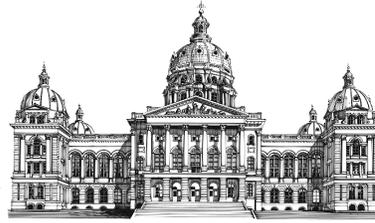


Iowa Legislative Fiscal Bureau

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State Capitol
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Tax and Revenue Anticipation Notes

ISSUE

Eliminating letter-of-credit costs for Tax and Revenue Anticipation Notes (TRANS) issuances.

AFFECTED AGENCIES

Office of the Treasurer

CODE AUTHORITY

Chapter 12.26, Code of Iowa

BACKGROUND

TRANS issuances are a form of State borrowing used to smooth out cash flow problems which arise when disbursement needs do not match the timing of revenue flows. TRANS issuance totals (in millions) on an annual basis since FY 1986 when Iowa first began issuing TRANS are as follows:

FY 1986 (actual)	FY 1987 (actual)	FY 1988 (actual)	FY1989 (actual)	FY1990 (actual)	FY 1991 (actual)	FY 1992 (actual)	FY 1993 (est)
\$452.0	\$463.0	\$205.0	\$230.0	\$250.0	\$355.0	\$330.0	\$360.0

Costs associated with a TRANS issuance include interest payments, printing costs, rating fees, letter-of-credit fees, legal fees, and investment banker fees. These costs are offset by investment income earned during the borrowing period. For FYs 1986 - 1990, the TRANS net effect on the General Fund was positive, resulting in net earnings from \$6.0 million to \$77,000. For FY 1991 and FY 1992, there were net costs to the General Fund of approximately \$500,000 and \$6.0 million respectively. Losses are replaced through the standing unlimited appropriation authority contained in Chapter 12.26, Code of Iowa.

States can reduce issuance costs by enhancing their credit rating to receive more favorable interest rates. For a TRANS, this may be done by obtaining a letter-of-credit from an appropriate financial institution. The letter-of-credit guarantees repayment to the bondholder on the note's due date in the event the State can not make full payment on that date. Iowa first obtained a letter-of-credit for a TRANS issuance in FY 1988. Letters-of-credit have been obtained for all subsequent TRANS issuances. Payments for letters-of-credit are shown in the table below:

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FY 1988 (actual)	FY 1989 (actual)	FY 1990 (actual)	FY 1991 (actual)	FY 1992 (actual)	FY 1993 (est)
\$119,153	\$125,940	\$49,907	\$211,039	\$708,844	\$1,260,000

The cost of obtaining a letter-of-credit is contingent upon the amount of the borrowing, the period of time the borrowing is outstanding, and the number of basis points required by the lending institution in consideration of the perceived risk (note: 100 basis points is equivalent to 1% of the loan). For FYs 1988 and 1989, only 5 basis points were required; for FYs 1990 - 1992, the number of points required increased to approximately 20 basis points. The FY 1993 letter-of-credit is anticipated to require 35 basis points. The increase in the basis points required for letters of credit stemmed primarily from regulatory changes which affected reserve requirements beginning FY 1990, and, for FY 1993, switching to more expensive European banks from Japanese banks which are perceived to be having problems.

ALTERNATIVES

By allowing interfund borrowing the potential exists to eliminate or reduce expense of the letter-of-credit. In theory, large stable State funds with a consistent balance could be pledged as an asset from which to borrow on the due date if the State were to default and eliminate the need for a letter of credit. Currently the market does not support interfund borrowing as an alternative to a letter of credit. The establishment of interfund borrowing while not a direct alternative to a letter of credit would help the overall state financial picture as seen by the underwriter by improving access to cash. An improved financial picture could help the State achieve the top rating and eliminate the need for the letter-of-credit.

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